



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201025078**
Release Date: 6/25/10
Date: 3/30/2010
UIL Code: 501.07-05
501.07-01

Contact Person:
Identification Number:
Contact Number:
Employer Identification Number:
Form Required To Be Filed:
Tax Years:

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(7).

Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Rob Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: 1/12/2010

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

Mr. X = your President
Mrs. X = your Secretary

A = a state
B = a date
C = a date
D = a date

UIL:

512.09-03
501-07-01
501.07-05

Dear

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(7). The basis for our conclusion is set forth below.

Issues

1. Do your commercial advertisements for public patronage constitute prima facie evidence that you are engaged in a commercial business rather than operating for social, recreational and similar non profit purposes? Yes, for the reasons described below.
2. Does your lack of a true social membership structure and your lack of significant social commingling between your reputed members prevent you from qualifying for exemption from income tax under section 501(c)(7) of the Internal Revenue Code? Yes, for the reasons described below.
3. Does inurement to your officers and founders also prevent you from qualifying for exemption from income tax under section 501(c)(7) of the Internal Revenue Code? Yes, for the reasons described below.

Letter 4034 (CG) (11-2005)
Catalog Number 47628K

Facts

- You were incorporated in the State of A on date B. Your articles of incorporation were signed only by Mrs. X, your Secretary and Director. You later made an amendment to your articles of incorporation on date C. Your amendment was also just signed by Mrs. X, your Secretary and Director.
- A color brochure advertisement that you submitted with your application for exemption stated that you were named for a village in Europe at which Mr. X, and prior to Mr. X, his family and ancestors made wine for over 500 years. This advertisement touted the heritage and expertise of Mr. X as a professional winemaker.
- Your articles stated that you were formed for the following purposes:
 - a. To encourage the appreciation of winemaking, promote the responsible use of wine, educate wine tasters and home wine makers, and to promote and support the healthful creation of wine made without sulfites
 - b. To carry on any and all activities permitted to a non-stock corporation under the laws of State A as may be helpful or appropriate for the achievement of the foregoing goals and purposes.
- Neither your original articles of incorporation nor the amendment thereto provided for a membership structure, for voting rights for members or for any other privileges or responsibilities for members.
- Although you applied for exemption under section 501(c)(7) of the Code, the amendments to your articles of incorporation unnecessarily added the routine purpose, dissolution and other provisions required to meet the organizational test of an exclusively educational organization described in section 501(c)(3) of the Code. In particular, your amended dissolution clause effectively prevented your members from sharing in the distribution of your assets upon your termination.
- Your application for exemption, Form 1024, confirmed that you were formed by, and continue to be controlled by your President and Director Mr. X and by your Secretary and Director Mrs. X.
- Initially, your application for exemption stated that your bylaws would include voting rights for members, meaning persons other than your President and Director Mr. X and your Secretary and Director, Mrs. X. However, you later provided a copy of your bylaws that were just signed by Mrs. X. Your bylaws stated in Article 5.2.2, "Members shall not be permitted to nominate or vote for directors." The only other provision in your bylaws that may pertain to members, meaning persons other than Mr. and Mrs. X, was Article IV which simply said, "The corporation shall have members."
- Your application indicated that you are open for business with the general public and that you charge fees to customers to make a barrel of wine. Although membership requirements were completely missing from your articles and bylaws, your application

for exemption stated that anyone over 21 years old automatically became a member upon paying the fee to make a barrel of wine at your facility.

- You submitted a copy of your "Harvest 2008 Fees and Application Form," which contained common commercial advertising terminology such as, "Space is limited so please apply early. *See special offer." Elsewhere this form said, "Exclusive Offer: \$ off your barrel membership. Be one of our first fifteen applicants to enjoy this additional savings."
- Your advertisement and application form also stated that for an annual fee ranging from approximately \$ to \$, depending on the type of barrel selected, a prospective member would receive from you grapes, a wooden barrel, bottles, corks, customized labels, usage of equipment, club membership, climate-controlled storage and daily monitoring of the wine for one year.
- Your advertisement and application form also stated that a membership could be shared between up to 6 persons. A space on the advertisement and application form allowed the prospective member to list the, "Names and addresses of other members sharing this barrel."
- In addition to your " 2008 Fees and Application Form," you also submitted with your application for tax exempt status the color brochure advertisement mentioned on page 2 of this letter in the second bullet. That advertisement described to the public the long history of Mr. X's winemaking family. The color brochure advertisement described Mr. X as a winemaker and it stated, "During fermentation and on a daily basis for the following year, your wine will be individually monitored by our winemaker."
- Your color brochure advertisement also stated, "In personalized sessions with our winemaker and his family, you can experience a centuries old tradition. You will be assisted through each step of the process in our state of the art facility."
- Your color brochure advertisement also referred to the fun that prospective members could have with their own friends, family and business associates (but not with other unrelated club members) during their individual winemaking activities at your facility.
- Your application for exemption indicated that your members' winemaking activities could occur either in a one on one session with your winemaker, or in a group composed of individuals of your members' own choosing with your winemaker. You estimated that your winemaker's activities would break down as follows.
 - a. Group sessions take up of 80% of your winemaker's time. A group consists of individual members who decide to share the cost of producing a barrel of wine, possibly along with their own friends, family members or business associates whom the individual member or members invite to their own winemaking activities. Your entire membership is not invited to attend these group sessions. You gave these examples of group sessions:

- i. A group had a wine crushing/baby shower. The men discussed wine making and the women held a baby shower. The group combined to crush the grapes then two weeks later they pressed the grapes and filled the barrel. One day each month the group came to taste the wine and top off the barrel.
- ii. A local businessman with eight employees consisted of a group. The event was paid for by the businessman. The group crushed approximately 24 cases of wine. They discussed winemaking techniques and enjoyed glasses of wine.
- iii. Six families agreed to share a barrel of wine. They came to the club to crush grapes.

The process for each group is to come to you to crush the grapes, at a later date the group presses the grapes and approximately nine months later they bottle the wine. After the wine is bottled it is for the members to take home.

- b. Individual sessions make up 20% of the time. These are one-on-one discussions and making of wine with the steward. Your application used the terms winemaker and wine steward interchangeably.
- You stated that when you are financially able, you plan to pay an annual salary of \$ to \$ to your winemaker or wine steward, currently Mr. X. You stated that this would constitute a reasonable amount of compensation for the services provided to you in comparison to what other employers pay for services of this type.
 - You submitted a copy of a commercial lease dated D between you as the tenant and Mr. and Mrs. X as the landlords. Mr. and Mrs. X signed the commercial lease under the heading "Landlord" and under the heading "Tenant," your name appeared but the only signature below your name was that of Mrs. X, using the title "Managing Director Duly Authorized."
 - Your commercial lease with Mr. and Mrs. X is for a square foot facility at a monthly rent of \$. The lease obliges you to pay late charges of % per month and annual interest on other unpaid amounts under the lease of %. Upon execution of the lease with Mr. and Mrs. X, Article 2.02 required you to pay to Mr. and Mrs. X a security deposit of \$. The lease required you to pay for the facility's maintenance and insurance and all utility bills.
 - Almost a year after you entered into the commercial lease agreement with Mr. and Mrs. X, they, as the landlords of the facility, obtained an appraisal which stated that the fair market value of the facility should produce monthly lease payments of approximately \$ for themselves as the landlords.
 - Your application also included a copy of the minutes of the meeting of your Board of Directors. The only persons present at that meeting were Mr. and Mrs. X. At this meeting Mr. and Mrs. X nominated themselves and then elected themselves as your initial Board of Directors and as your President and Secretary respectively. Also at this meeting, Mr. and Mrs. X approved, ratified and adopted all acts taken by your

incorporator, who was Mrs. X. The minutes of this meeting said nothing about members or social activities.

- Your application for exemption stated that you had members. You also stated that in the future, you plan to conduct more social activities for larger groups of your members. However, Mr. and Mrs. X have made all of your business decisions thus far with no participation whatsoever by the reputed members and Mr. and Mrs. X retained complete control of you. Your reputed members still have no voting rights nor can they participate in the distribution of your assets upon your dissolution.
- Your members will primarily bottle the wine on your premises and consume the wine off of your premises.

Law

Section 501(c)(7) of the Internal Revenue Code exempts clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earning of which inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1(b) of the Income Tax Regulations states that a club which engages in business, such as making its social and recreational facilities available to the general public or selling real estate, timber, or other products, is not organized and operated for pleasure, recreation and other non-profitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes.

Revenue Ruling 55-716, 1955-2 C.B. 263, stated that an organization formed for the purpose of furnishing television antenna service to its members was not entitled to exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954. That organization was formed for the purpose of furnishing and providing television antenna service to members upon payment of a stipulated membership fee and a monthly charge for maintenance of the antenna. Income was derived from membership fees and service charges. Funds were expended for equipment, maintenance and miscellaneous expenses. Per the ruling, the term "club" as used in the Code contemplates the commingling of members, one with the other, in fellowship. Personal contacts and fellowship must also play a material part in the life of an organization in order for it to come within the meaning of the term "club". The only activity of the organization depicted in the ruling was the operation and maintenance of a television antenna system providing television services to its members in their homes. Fellowship did not constitute a material part of the life of the organization, since the services did not afford an opportunity for personal contacts and fellowship among members receiving such service.

Revenue Ruling 58-588, 1958-2 C.B. 265 denied exemption under section 501(c)(7) to an organization whose so-called members had no voice in the management of the organization and whose only rights were to use the organization's facilities upon the payment of the specified

fees.

Revenue Ruling 58-589, 1958-2 C. B. 256 stated that in making a determination whether an organization comes within the provisions of section 501(c)(7) of the Code, all facts pertaining to its form of organization, method of operation and activities should be considered. An organization must establish (1) that is a club both organized and operated for pleasure, recreation and other non-profitable purposes and (2) that no part of its net earning inures to the benefit of any private shareholder or individual. To meet the first requirement, there must be an established membership of individuals, personal contacts and fellowship. A commingling of the members must play a material part in the life of the organization.

Revenue Ruling 68-535, 1968-2 C. B. 219 stated that a social club that regularly sold liquor to its members for consumption off its premises was not entitled to exemption under section 501(c)(7) of the Code. The club provided a variety of social and athletic activities for its members. It operated a clubhouse, which included restaurant and bar facilities. In addition to selling liquor to members in the bar and restaurant, the club also regularly sold liquor by the bottle to members for consumption off the premises. Purchases could be made by members only. The ruling held that the regular sale of liquor under the circumstances described was a service to the members that was not in furtherance of a social club's exempt purpose. Since such activity was neither social nor recreational, the club was not operated for pleasure, recreation and other non-profitable purposes within the meaning of section 501(c)(7) of the Code.

Under Revenue Ruling 69-635, 1969-2 C. B. 125, an automobile club whose principal activity was rendering automobile services to its members but which had no significant social activities did not qualify for exemption under section 501(c)(7) of the Code. The purpose of the organization was to promote highway safety and to provide various motoring conveniences to its members. The organization did not carry on any significant social activities. The principal activity of this organization was the rendering of automobile services to its members. Most of the services offered were of a type generally available to motorists on a commercial basis. The rendition of such services was not in the nature of pleasure or recreation within the meaning of the statute.

Application of Law

You fail to meet the requirement of section 501(c)(7) of the Code that your earnings must not inure to the benefit of private individuals. You are completely controlled by your founders Mr. and Mrs. X, who are in the winemaking business or who have winemaking as their profession. Mr. and Mrs. X, acting as both landlord and tenant, rented their winemaking facility to you. The fact that Mr. and Mrs. X charged you rent based on the fair market value of their facility (which was only established almost a year after the date of the lease agreement) does not mean that they did not realize a financial gain from this transaction. On the contrary, a prudent landlord would expect to make a financial gain by leasing a facility at a monthly rent equivalent to its fair market value. Renting the facility to you, an entity that they completely controlled, also relieved Mr. and Mrs. X of the expense of marketing the facility to an unknown, unrelated tenant. Thus, the lease between the closely related parties produced prohibited inurement and this reason,

standing alone, constitutes sufficient justification for denying your request for exemption from income tax under section 501(c)(7), independent of the other reasons described in this letter. Please refer back to Issue #3 on page 1 of this letter.

Your plan to pay Mr. X as your wine steward or winemaker as soon as you are financially able to do so confirms that your earnings will inure to the benefit of your founders, Mr. and Mrs. X. You asserted that the annual salary that you will pay Mr. X will be reasonable in comparison to salaries paid by other employers for employees providing similar services. However, the inurement derives more from your hiring methodology than from the specific amount of the compensation. As stated above, Mr. and Mrs. X formed you and made all of your business decisions. Your plan (formulated by Mr. and Mrs. X) to hire Mr. X provides a valuable economic benefit to Mr. X even if his salary does not exceed what is reasonable for his services. At a minimum, this arrangement relieves Mr. X of the time, effort and expense of seeking employment from an unrelated employer. This second form of inurement, standing alone, provides sufficient justification for the proposed denial of exemption independent of the other reasons described in this letter. Please refer back to Issue #3 on page 1 of this letter.

The third way in which your earnings inured to the benefit of Mr. X was through your commercial advertisements that touted his winemaking heritage and expertise, thus promoting his career and improving his earning potential at no expense to Mr. X. This third form of inurement, standing alone, provides sufficient justification for the proposed denial of exemption, independent of the other reasons described in this letter. Please refer back to Issue #3 on page 1 of this letter.

Turning from the Code to section 1.501(c)(7)-1(b) of the Regulations, we found that your commercial advertisements for public patronage of your wine making facility constituted prima facie evidence that you are running a business rather than operating a club for social, recreational and similar non profit purposes under Code section 501(c)(7). Your advertisements and application forms stated that any person wishing to purchase your services and products automatically becomes one of your members upon payment of a large fee. Membership, as you define it, confers no voting rights or any other of the privileges and responsibilities normally associated with membership in a genuine social club. Based on the facts and circumstances, the persons whom you call members are essentially the customers of your commercial business operation. Thus your commercial advertising for public patronage of you facilities, standing alone, provides sufficient justification for the proposed denial of exempt status, independent of the other reasons described in this letter. Please refer back to Issue #1 on page 1 of this letter of this letter.

Turning from the Regulations to the various revenue rulings cited above, we found that the common theme is that to qualify for exemption under section 501(c)(7) of the Code, an organization must have a genuine social membership structure and that the central function of an organization must be the provision of non profit social and recreational activities at which a substantial commingling of the members occurs. As stated above, your reputed members cannot vote for your officers or directors and they cannot participate in any distribution of your assets upon your termination. You were not formed by your reputed members but rather by Mr. and Mrs. X. You designate persons as your members as soon as they pay the fee to obtain

your services and products. However, aside from your designation, the facts and circumstances indicate that these persons are essentially customers of your business operation and not genuine members of a non profit social club. Your lack of a genuine social membership structure provides sufficient justification, standing alone, for the proposed denial of exempt status, independent of the other reasons described in this letter. Please refer back to Issue #2 on page 1 of this letter.

Another common theme that we noticed in the above cited revenue rulings is that to qualify for exemption under section 501(c)(7), an organization must attain a substantial degree of social commingling of members in conjunction with its activities, events and services. Your advertisements to the public stress that in exchange for their substantial fees to you, your members will receive value in the form of winemaking services and winemaking products from you. Your advertisements and your application confirm that any social enjoyment and commingling of your members is at the option of the individual members and is incidental to their purchase of your winemaking services and winemaking products. A substantial part of your winemaking activities are "one on one" between one of your members and your winemaker. Admittedly, you also have a large number of winemaking activities at which your winemaker serves small sub groups of your members, but these sub groups primarily define themselves through your commercial advertising and application process, often for the purpose of saving themselves money by splitting your fee for winemaking services and products. We also acknowledge that you now plan to begin sponsoring larger, more formal social gatherings to which you will invite a higher percentage of your membership. However, our analysis of your application and all of the relevant facts and circumstances indicates that adding some social events for larger numbers of members will not alter your core business function of providing winemaking services and winemaking products to the public for a fee. Thus, the lack of substantial social commingling of your members during your activities, events, and services, provides sufficient justification, standing alone, for the proposed denial of exempt status, independent of the other reasons described in this letter. Please refer back to Issue #2 on page 1 on this letter.

Here are our observations as to how the above cited revenue rulings reinforce the proposed denial of your application for exempt status under section 501(c)(7):

- You are substantially similar to the organization denied in Revenue Ruling 55-716 in that the core of your business operation is to provide valuable services and products to customers for a fee. In that case, fellowship did not constitute a material part of the life of the organization. That organization was formed to sell a valuable service to the public and the so-called members of that organization joined that organization for the purpose of buying those services. You were formed to sell winemaking services and winemaking products to the public for a fee and the main reason that your so-called members join you is to purchase your winemaking services and winemaking products. The fellowship and social enjoyment that your members may experience in conjunction with your events, activities and services is incidental and secondary to your core business mission of selling your services and products to the public for a fee. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.

- A major reason for the denial of the organization described in Revenue Ruling 58-588 was that the so-called members of the organization had no voice in the management of the organization and that their true relationship to the organization was that of a customer to a service providing business. You are similar in that Mr. and Mrs. X formed you and completely control you. Your so-called members have no voice in your management. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.
- Revenue Ruling 58-589 confirms that to qualify for exemption under section 501(c)(7), there must be an established membership of individuals and that an organization's earnings must not inure to private persons. You fail these criteria because you do not have a genuine membership structure but are instead completely controlled by Mr. and Mrs. X. and your earnings inure to them in the three ways described above. Please refer back to Issue #2 and Issue #3 on page 1 of this letter.
- One of the main reasons that the organization described in Revenue Ruling 68-535 was denied was that a substantial part of its business was the sale of liquor to its members to consume off premises. You sell your members winemaking services and winemaking products in order that you and they may produce bottles of wine that the members primarily consume off premises. In a manner similar to the organization described in the revenue ruling, this confirms that your operation is more similar to a commercial business than to a non-profit social club. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.
- Revenue Ruling 69-635 described another organization that was denied exemption under section 501(c)(7) because it was primarily formed to sell valuable services to the public for a fee. That organization's core business was not providing its membership with opportunities to commingle with one another in the venue of a non profit social club. The facts in your case indicate that your sale of winemaking services and winemaking products to the public for a fee is not inherently social in nature. We acknowledge that some fellowship and social enjoyment happens during some of your winemaking activities but that is secondary and incidental to your core business function of selling the winemaking services and winemaking products to the public for a fee. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.

Applicant's Position

As to the lack of social commingling as your core business function, you stated that you plan to start sponsoring weekly social activities to which you will invite all members.

As to inurement from the lease, you provided an appraisal obtained by Mr. and Mrs. X which stated that they, as the landlords, should expect to receive monthly lease payments of about \$3,600 based on the fair market value of their facility.

As to future inurement from Mr. X's salary, you asserted that \$ to \$ would be a reasonable amount of compensation based on what similar employers would pay for similar services.

Service Response to Applicant's Position

After considering your position, we concluded that all of the reasons that we previously cited for proposing to deny your application for exemption under section 501(c)(7) are still valid.

As we stated above, a lease with a fair market rent paid to the landlord still conveys a financial gain to the landlord, especially if, as in this case, the landlord controls the tenant. Likewise, there is an economic benefit in securing employment even when the salary is comparable to that paid by other employers for similar services, especially if, as in this case, the employee controls the employer.

As to adding more purely social events for larger groups of your members to achieve more commingling among your general membership, we concluded that, even if that could be deemed an effective corrective measure, it would only correct one of the above described reasons for the proposed denial and therefore the correction would be insufficient to justify the approval of exempt status under section 501(c)(7). Also, even if this was deemed to be an effective corrective measure, we decided that it would only help you to claim exemption prospectively and not retroactively.

However, we do not believe that adding the broader social events will help you to achieve exemption at all, either retroactively or prospectively. Even with the new broader social activities, your core business operation will remain the selling of winemaking services and winemaking products to the public for a fee, and therefore, fellowship and social commingling among your so-called members will remain secondary and incidental to that core business function. Furthermore, your actual relationship to your members will continue to be that of a commercial service provider to its customers.

Conclusion

You do not qualify for exemption under 501(c)(7) of the Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, under the penalties of perjury, within 30 days from the date of this letter.

We will consider your statement and decide if that information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in the enclosed Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

Types of information that should be included in your protest can be found on page 2 of Publication 892. The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

Your protest will be considered incomplete without this statement.

Your protest should also clearly say that if the issues cannot be resolved at our level, you request that we transfer your case to our independent Appeals office.

If your representative submits the protest, a substitute declaration must be included stating that the representative prepared the protest and accompanying documents; and whether the representative knows personally that the statements of facts contained in the protest and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. To be represented during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this proposed determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter to you. That letter will provide information about filing tax returns and other matters.

If you do decide to protest, please send your protest statement, Form 2848 and any supporting documents to the applicable address:

Mail to:

Internal Revenue Service
EO Determinations Quality Assurance
Room 7-008
P.O. Box 2508
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service
EO Determinations Quality Assurance
550 Main Street, Room 7-008
Cincinnati, OH 45202

Also, mark your protest to the attention of the IRS contact person shown on page 1 of this letter.

You may also fax your protest using the fax number shown in the heading of this letter. If you fax your protest please call the person identified in the heading of this letter to confirm that he received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert S. Choi
Director, Exempt Organizations
Rulings & Agreements



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: 1/12/2010

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

Mr. X = your President
Mrs. X = your Secretary

A = a state
B = a date
C = a date
D = a date

UIL:

512.09-03
501-07-01
501.07-05

Dear

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(7). The basis for our conclusion is set forth below.

Issues

1. Do your commercial advertisements for public patronage constitute prima facie evidence that you are engaged in a commercial business rather than operating for social, recreational and similar non profit purposes? Yes, for the reasons described below.
2. Does your lack of a true social membership structure and your lack of significant social commingling between your reputed members prevent you from qualifying for exemption from income tax under section 501(c)(7) of the Internal Revenue Code? Yes, for the reasons described below.
3. Does inurement to your officers and founders also prevent you from qualifying for exemption from income tax under section 501(c)(7) of the Internal Revenue Code? Yes, for the reasons described below.

Letter 4034 (CG) (11-2005)
Catalog Number 47628K

Facts

- You were incorporated in the State of A on date B. Your articles of incorporation were signed only by Mrs. X, your Secretary and Director. You later made an amendment to your articles of incorporation on date C. Your amendment was also just signed by Mrs. X, your Secretary and Director.
- A color brochure advertisement that you submitted with your application for exemption stated that you were named for a village in Europe at which Mr. X, and prior to Mr. X, his family and ancestors made wine for over 500 years. This advertisement touted the heritage and expertise of Mr. X as a professional winemaker.
- Your articles stated that you were formed for the following purposes:
 - a. To encourage the appreciation of winemaking, promote the responsible use of wine, educate wine tasters and home wine makers, and to promote and support the healthful creation of wine made without sulfites
 - b. To carry on any and all activities permitted to a non-stock corporation under the laws of State A as may be helpful or appropriate for the achievement of the foregoing goals and purposes.
- Neither your original articles of incorporation nor the amendment thereto provided for a membership structure, for voting rights for members or for any other privileges or responsibilities for members.
- Although you applied for exemption under section 501(c)(7) of the Code, the amendments to your articles of incorporation unnecessarily added the routine purpose, dissolution and other provisions required to meet the organizational test of an exclusively educational organization described in section 501(c)(3) of the Code. In particular, your amended dissolution clause effectively prevented your members from sharing in the distribution of your assets upon your termination.
- Your application for exemption, Form 1024, confirmed that you were formed by, and continue to be controlled by your President and Director Mr. X and by your Secretary and Director Mrs. X.
- Initially, your application for exemption stated that your bylaws would include voting rights for members, meaning persons other than your President and Director Mr. X and your Secretary and Director, Mrs. X. However, you later provided a copy of your bylaws that were just signed by Mrs. X. Your bylaws stated in Article 5.2.2, "Members shall not be permitted to nominate or vote for directors." The only other provision in your bylaws that may pertain to members, meaning persons other than Mr. and Mrs. X, was Article IV which simply said, "The corporation shall have members."
- Your application indicated that you are open for business with the general public and that you charge fees to customers to make a barrel of wine. Although membership requirements were completely missing from your articles and bylaws, your application

for exemption stated that anyone over 21 years old automatically became a member upon paying the fee to make a barrel of wine at your facility.

- You submitted a copy of your "Harvest 2008 Fees and Application Form," which contained common commercial advertising terminology such as, "Space is limited so please apply early. *See special offer." Elsewhere this form said, "Exclusive Offer: \$ off your barrel membership. Be one of our first fifteen applicants to enjoy this additional savings."
- Your advertisement and application form also stated that for an annual fee ranging from approximately \$ to \$, depending on the type of barrel selected, a prospective member would receive from you grapes, a wooden barrel, bottles, corks, customized labels, usage of equipment, club membership, climate-controlled storage and daily monitoring of the wine for one year.
- Your advertisement and application form also stated that a membership could be shared between up to 6 persons. A space on the advertisement and application form allowed the prospective member to list the, "Names and addresses of other members sharing this barrel."
- In addition to your " 2008 Fees and Application Form," you also submitted with your application for tax exempt status the color brochure advertisement mentioned on page 2 of this letter in the second bullet. That advertisement described to the public the long history of Mr. X's winemaking family. The color brochure advertisement described Mr. X as a winemaker and it stated, "During fermentation and on a daily basis for the following year, your wine will be individually monitored by our winemaker."
- Your color brochure advertisement also stated, "In personalized sessions with our winemaker and his family, you can experience a centuries old tradition. You will be assisted through each step of the process in our state of the art facility."
- Your color brochure advertisement also referred to the fun that prospective members could have with their own friends, family and business associates (but not with other unrelated club members) during their individual winemaking activities at your facility.
- Your application for exemption indicated that your members' winemaking activities could occur either in a one on one session with your winemaker, or in a group composed of individuals of your members' own choosing with your winemaker. You estimated that your winemaker's activities would break down as follows.
 - a. Group sessions take up of 80% of your winemaker's time. A group consists of individual members who decide to share the cost of producing a barrel of wine, possibly along with their own friends, family members or business associates whom the individual member or members invite to their own winemaking activities. Your entire membership is not invited to attend these group sessions. You gave these examples of group sessions:

- i. A group had a wine crushing/baby shower. The men discussed wine making and the women held a baby shower. The group combined to crush the grapes then two weeks later they pressed the grapes and filled the barrel. One day each month the group came to taste the wine and top off the barrel.
- ii. A local businessman with eight employees consisted of a group. The event was paid for by the businessman. The group crushed approximately 24 cases of wine. They discussed winemaking techniques and enjoyed glasses of wine.
- iii. Six families agreed to share a barrel of wine. They came to the club to crush grapes.

The process for each group is to come to you to crush the grapes, at a later date the group presses the grapes and approximately nine months later they bottle the wine. After the wine is bottled it is for the members to take home.

- b. Individual sessions make up 20% of the time. These are one-on-one discussions and making of wine with the steward. Your application used the terms winemaker and wine steward interchangeably.
- You stated that when you are financially able, you plan to pay an annual salary of \$ to \$ to your winemaker or wine steward, currently Mr. X. You stated that this would constitute a reasonable amount of compensation for the services provided to you in comparison to what other employers pay for services of this type.
 - You submitted a copy of a commercial lease dated D between you as the tenant and Mr. and Mrs. X as the landlords. Mr. and Mrs. X signed the commercial lease under the heading "Landlord" and under the Heading "Tenant," your name appeared but the only signature below your name was that of Mrs. X , using the title "Managing Director Duly Authorized."
 - Your commercial lease with Mr. and Mrs. X is for a square foot facility at a monthly rent of \$. The lease obliges you to pay late charges of % per month and annual interest on other unpaid amounts under the lease of %. Upon execution of the lease with Mr. and Mrs. X, Article 2.02 required you to pay to Mr. and Mrs. X a security deposit of \$. The lease required you to pay for the facility's maintenance and insurance and all utility bills.
 - Almost a year after you entered into the commercial lease agreement with Mr. and Mrs. X, they, as the landlords of the facility, obtained an appraisal which stated that the fair market value of the facility should produce monthly lease payments of approximately \$ for themselves as the landlords.
 - Your application also included a copy of the minutes of the meeting of your Board of Directors. The only persons present at that meeting were Mr. and Mrs. X. At this meeting Mr. and Mrs. X nominated themselves and then elected themselves as your initial Board of Directors and as your President and Secretary respectively. Also at this meeting, Mr. and Mrs. X approved, ratified and adopted all acts taken by your

incorporator, who was Mrs. X. The minutes of this meeting said nothing about members or social activities.

- Your application for exemption stated that you had members. You also stated that in the future, you plan to conduct more social activities for larger groups of your members. However, Mr. and Mrs. X have made all of your business decisions thus far with no participation whatsoever by the reputed members and Mr. and Mrs. X retained complete control of you. Your reputed members still have no voting rights nor can they participate in the distribution of your assets upon your dissolution.
- Your members will primarily bottle the wine on your premises and consume the wine off of your premises.

Law

Section 501(c)(7) of the Internal Revenue Code exempts clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earning of which inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1(b) of the Income Tax Regulations states that a club which engages in business, such as making its social and recreational facilities available to the general public or selling real estate, timber, or other products, is not organized and operated for pleasure, recreation and other non-profitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes.

Revenue Ruling 55-716, 1955-2 C.B. 263, stated that an organization formed for the purpose of furnishing television antenna service to its members was not entitled to exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954. That organization was formed for the purpose of furnishing and providing television antenna service to members upon payment of a stipulated membership fee and a monthly charge for maintenance of the antenna. Income was derived from membership fees and service charges. Funds were expended for equipment, maintenance and miscellaneous expenses. Per the ruling, the term "club" as used in the Code contemplates the commingling of members, one with the other, in fellowship. Personal contacts and fellowship must also play a material part in the life of an organization in order for it to come within the meaning of the term "club". The only activity of the organization depicted in the ruling was the operation and maintenance of a television antenna system providing television services to its members in their homes. Fellowship did not constitute a material part of the life of the organization, since the services did not afford an opportunity for personal contacts and fellowship among members receiving such service.

Revenue Ruling 58-588, 1958-2 C.B. 265 denied exemption under section 501(c)(7) to an organization whose so-called members had no voice in the management of the organization and whose only rights were to use the organization's facilities upon the payment of the specified

fees.

Revenue Ruling 58-589, 1958-2 C. B. 256 stated that in making a determination whether an organization comes within the provisions of section 501(c)(7) of the Code, all facts pertaining to its form of organization, method of operation and activities should be considered. An organization must establish (1) that is a club both organized and operated for pleasure, recreation and other non-profitable purposes and (2) that no part of its net earning inures to the benefit of any private shareholder or individual. To meet the first requirement, there must be an established membership of individuals, personal contacts and fellowship. A commingling of the members must play a material part in the life of the organization.

Revenue Ruling 68-535, 1968-2 C. B. 219 stated that a social club that regularly sold liquor to its members for consumption off its premises was not entitled to exemption under section 501(c)(7) of the Code. The club provided a variety of social and athletic activities for its members. It operated a clubhouse, which included restaurant and bar facilities. In addition to selling liquor to members in the bar and restaurant, the club also regularly sold liquor by the bottle to members for consumption off the premises. Purchases could be made by members only. The ruling held that the regular sale of liquor under the circumstances described was a service to the members that was not in furtherance of a social club's exempt purpose. Since such activity was neither social nor recreational, the club was not operated for pleasure, recreation and other non-profitable purposes within the meaning of section 501(c)(7) of the Code.

Under Revenue Ruling 69-635, 1969-2 C. B. 125, an automobile club whose principal activity was rendering automobile services to its members but which had no significant social activities did not qualify for exemption under section 501(c)(7) of the Code. The purpose of the organization was to promote highway safety and to provide various motoring conveniences to its members. The organization did not carry on any significant social activities. The principal activity of this organization was the rendering of automobile services to its members. Most of the services offered were of a type generally available to motorists on a commercial basis. The rendition of such services was not in the nature of pleasure or recreation within the meaning of the statute.

Application of Law

You fail to meet the requirement of section 501(c)(7) of the Code that your earnings must not inure to the benefit of private individuals. You are completely controlled by your founders Mr. and Mrs. X, who are in the winemaking business or who have winemaking as their profession. Mr. and Mrs. X, acting as both landlord and tenant, rented their winemaking facility to you. The fact that Mr. and Mrs. X charged you rent based on the fair market value of their facility (which was only established almost a year after the date of the lease agreement) does not mean that they did not realize a financial gain from this transaction. On the contrary, a prudent landlord would expect to make a financial gain by leasing a facility at a monthly rent equivalent to its fair market value. Renting the facility to you, an entity that they completely controlled, also relieved Mr. and Mrs. X of the expense of marketing the facility to an unknown, unrelated tenant. Thus, the lease between the closely related parties produced prohibited inurement and this reason,

standing alone, constitutes sufficient justification for denying your request for exemption from income tax under section 501(c)(7), independent of the other reasons described in this letter. Please refer back to Issue #3 on page 1 of this letter.

Your plan to pay Mr. X as your wine steward or winemaker as soon as you are financially able to do so confirms that your earnings will inure to the benefit of your founders, Mr. and Mrs. X. You asserted that the annual salary that you will pay Mr. X will be reasonable in comparison to salaries paid by other employers for employees providing similar services. However, the inurement derives more from your hiring methodology than from the specific amount of the compensation. As stated above, Mr. and Mrs. X formed you and made all of your business decisions. Your plan (formulated by Mr. and Mrs. X) to hire Mr. X provides a valuable economic benefit to Mr. X even if his salary does not exceed what is reasonable for his services. At a minimum, this arrangement relieves Mr. X of the time, effort and expense of seeking employment from an unrelated employer. This second form of inurement, standing alone, provides sufficient justification for the proposed denial of exemption independent of the other reasons described in this letter. Please refer back to Issue #3 on page 1 of this letter.

The third way in which your earnings inured to the benefit of Mr. X was through your commercial advertisements that touted his winemaking heritage and expertise, thus promoting his career and improving his earning potential at no expense to Mr. X. This third form of inurement, standing alone, provides sufficient justification for the proposed denial of exemption, independent of the other reasons described in this letter. Please refer back to Issue #3 on page 1 of this letter.

Turning from the Code to section 1.501(c)(7)-1(b) of the Regulations, we found that your commercial advertisements for public patronage of your wine making facility constituted prima facie evidence that you are running a business rather than operating a club for social, recreational and similar non profit purposes under Code section 501(c)(7). Your advertisements and application forms stated that any person wishing to purchase your services and products automatically becomes one of your members upon payment of a large fee. Membership, as you define it, confers no voting rights or any other of the privileges and responsibilities normally associated with membership in a genuine social club. Based on the facts and circumstances, the persons whom you call members are essentially the customers of your commercial business operation. Thus your commercial advertising for public patronage of you facilities, standing alone, provides sufficient justification for the proposed denial of exempt status, independent of the other reasons described in this letter. Please refer back to Issue #1 on page 1 of this letter of this letter.

Turning from the Regulations to the various revenue rulings cited above, we found that the common theme is that to qualify for exemption under section 501(c)(7) of the Code, an organization must have a genuine social membership structure and that the central function of an organization must be the provision of non profit social and recreational activities at which a substantial commingling of the members occurs. As stated above, your reputed members cannot vote for your officers or directors and they cannot participate in any distribution of your assets upon your termination. You were not formed by your reputed members but rather by Mr. and Mrs. X. You designate persons as your members as soon as they pay the fee to obtain

your services and products. However, aside from your designation, the facts and circumstances indicate that these persons are essentially customers of your business operation and not genuine members of a non profit social club. Your lack of a genuine social membership structure provides sufficient justification, standing alone, for the proposed denial of exempt status, independent of the other reasons described in this letter. Please refer back to Issue #2 on page 1 of this letter.

Another common theme that we noticed in the above cited revenue rulings is that to qualify for exemption under section 501(c)(7), an organization must attain a substantial degree of social commingling of members in conjunction with its activities, events and services. Your advertisements to the public stress that in exchange for their substantial fees to you, your members will receive value in the form of winemaking services and winemaking products from you. Your advertisements and your application confirm that any social enjoyment and commingling of your members is at the option of the individual members and is incidental to their purchase of your winemaking services and winemaking products. A substantial part of your winemaking activities are "one on one" between one of your members and your winemaker. Admittedly, you also have a large number of winemaking activities at which your winemaker serves small sub groups of your members, but these sub groups primarily define themselves through your commercial advertising and application process, often for the purpose of saving themselves money by splitting your fee for winemaking services and products. We also acknowledge that you now plan to begin sponsoring larger, more formal social gatherings to which you will invite a higher percentage of your membership. However, our analysis of your application and all of the relevant facts and circumstances indicates that adding some social events for larger numbers of members will not alter your core business function of providing winemaking services and winemaking products to the public for a fee. Thus, the lack of substantial social commingling of your members during your activities, events, and services, provides sufficient justification, standing alone, for the proposed denial of exempt status, independent of the other reasons described in this letter. Please refer back to Issue #2 on page 1 on this letter.

Here are our observations as to how the above cited revenue rulings reinforce the proposed denial of your application for exempt status under section 501(c)(7):

- You are substantially similar to the organization denied in Revenue Ruling 55-716 in that the core of your business operation is to provide valuable services and products to customers for a fee. In that case, fellowship did not constitute a material part of the life of the organization. That organization was formed to sell a valuable service to the public and the so-called members of that organization joined that organization for the purpose of buying those services. You were formed to sell winemaking services and winemaking products to the public for a fee and the main reason that your so-called members join you is to purchase your winemaking services and winemaking products. The fellowship and social enjoyment that your members may experience in conjunction with your events, activities and services is incidental and secondary to your core business mission of selling your services and products to the public for a fee. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.

- A major reason for the denial of the organization described in Revenue Ruling 58-588 was that the so-called members of the organization had no voice in the management of the organization and that their true relationship to the organization was that of a customer to a service providing business. You are similar in that Mr. and Mrs. X formed you and completely control you. Your so-called members have no voice in your management. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.
- Revenue Ruling 58-589 confirms that to qualify for exemption under section 501(c)(7), there must be an established membership of individuals and that an organization's earnings must not inure to private persons. You fail these criteria because you do not have a genuine membership structure but are instead completely controlled by Mr. and Mrs. X. and your earnings inure to them in the three ways described above. Please refer back to Issue #2 and Issue #3 on page 1 of this letter.
- One of the main reasons that the organization described in Revenue Ruling 68-535 was denied was that a substantial part of its business was the sale of liquor to its members to consume off premises. You sell your members winemaking services and winemaking products in order that you and they may produce bottles of wine that the members primarily consume off premises. In a manner similar to the organization described in the revenue ruling, this confirms that your operation is more similar to a commercial business than to a non-profit social club. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.
- Revenue Ruling 69-635 described another organization that was denied exemption under section 501(c)(7) because it was primarily formed to sell valuable services to the public for a fee. That organization's core business was not providing its membership with opportunities to commingle with one another in the venue of a non profit social club. The facts in your case indicate that your sale of winemaking services and winemaking products to the public for a fee is not inherently social in nature. We acknowledge that some fellowship and social enjoyment happens during some of your winemaking activities but that is secondary and incidental to your core business function of selling the winemaking services and winemaking products to the public for a fee. Please refer back to Issue #1 and Issue #2 on page 1 of this letter.

Applicant's Position

As to the lack of social commingling as your core business function, you stated that you plan to start sponsoring weekly social activities to which you will invite all members.

As to inurement from the lease, you provided an appraisal obtained by Mr. and Mrs. X which stated that they, as the landlords, should expect to receive monthly lease payments of about \$3,600 based on the fair market value of their facility.

As to future inurement from Mr. X's salary, you asserted that \$ to \$ would be a reasonable amount of compensation based on what similar employers would pay for similar services.

Service Response to Applicant's Position

After considering your position, we concluded that all of the reasons that we previously cited for proposing to deny your application for exemption under section 501(c)(7) are still valid.

As we stated above, a lease with a fair market rent paid to the landlord still conveys a financial gain to the landlord, especially if, as in this case, the landlord controls the tenant. Likewise, there is an economic benefit in securing employment even when the salary is comparable to that paid by other employers for similar services, especially if, as in this case, the employee controls the employer.

As to adding more purely social events for larger groups of your members to achieve more commingling among your general membership, we concluded that, even if that could be deemed an effective corrective measure, it would only correct one of the above described reasons for the proposed denial and therefore the correction would be insufficient to justify the approval of exempt status under section 501(c)(7). Also, even if this was deemed to be an effective corrective measure, we decided that it would only help you to claim exemption prospectively and not retroactively.

However, we do not believe that adding the broader social events will help you to achieve exemption at all, either retroactively or prospectively. Even with the new broader social activities, your core business operation will remain the selling of winemaking services and winemaking products to the public for a fee, and therefore, fellowship and social commingling among your so-called members will remain secondary and incidental to that core business function. Furthermore, your actual relationship to your members will continue to be that of a commercial service provider to its customers.

Conclusion

You do not qualify for exemption under 501(c)(7) of the Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, under the penalties of perjury, within 30 days from the date of this letter.

We will consider your statement and decide if that information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in the enclosed Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

Types of information that should be included in your protest can be found on page 2 of Publication 892. The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

Your protest will be considered incomplete without this statement.

Your protest should also clearly say that if the issues cannot be resolved at our level, you request that we transfer your case to our independent Appeals office.

If your representative submits the protest, a substitute declaration must be included stating that the representative prepared the protest and accompanying documents; and whether the representative knows personally that the statements of facts contained in the protest and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. To be represented during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this proposed determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter to you. That letter will provide information about filing tax returns and other matters.

If you do decide to protest, please send your protest statement, Form 2848 and any supporting documents to the applicable address:

Mail to:

Internal Revenue Service
EO Determinations Quality Assurance
Room 7-008
P.O. Box 2508
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service
EO Determinations Quality Assurance
550 Main Street, Room 7-008
Cincinnati, OH 45202

Also, mark your protest to the attention of the IRS contact person shown on page 1 of this letter.

You may also fax your protest using the fax number shown in the heading of this letter. If you fax your protest please call the person identified in the heading of this letter to confirm that he received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert S. Choi
Director, Exempt Organizations
Rulings & Agreements